

Where To Invest Your Money In 2006

As the new year kicks off, two starkly opposing viewpoints dominate Wall Street.

A pessimistic camp believes the U.S. economy has entered the downward phase of the business cycle, or soon will. "A major theme heading into 2006 is a rather significant economic deceleration," says Stephen Wood, portfolio strategist at Russell Investment Group in Tacoma, Washington, an investment management firm. Many with this outlook eye 2006 as a tough time to make money.

One reason for trepidation is the small current gap between short- and long-term interest rates. While short-term rates have risen steadily, there have been minimal increases in rates for intermediate- to long-term loans and bonds, resulting in a so-called flat yield curve. That often occurs in a cycle's late stages. Another concern is moderating spending by consumers, who account for two-thirds of economic activity in the United States. High energy costs could dent household budgets and hurt spending in other areas, Wood says. Higher long-term interest rates would have a similar effect on homeowners with variable-rate mortgages, and could end the refinancing craze that has spurred consumer spending the past few years.

Moreover, the Federal Reserve Bank began raising short-term rates more than 18 months ago to slow growth and stifle inflation. A constricting effect should be felt this year, the argument goes, particularly if the central bank continues hiking rates-and the chances of that happening are probably increased by the January 31 retirement of long-time Fed chairman Alan Greenspan. New Fed chairs "can be quick to pull the trigger and raise interest rates," says economist Quincy Krosby, chief investment strategist at The Hartford, the investment and insurance company in Connecticut. "Most new Fed chairmen want to show the world their inflation-fighting credentials."

Then there's the bullish side of the market. These investors concede growth may diminish but argue the economy will remain reasonably vibrant, Krosby explains. They contend that companies are overdue to upgrade technology, and spending on tech could compensate for retrenchment by consumers. "If Fed tightening slows the economy without pushing it into recession, the stock market could-and should-respond positively when it perceives the Fed is nearly finished raising short-term interest rates," Krosby says.

Which forecast, if either, will prevail?

It's impossible to know, but this much seems likely: Short-term rates will rise and lift yields, perhaps to 5% or higher, on money markets, Treasury bills, and other cash holdings. Conservative investors and fearful bears should appreciate that.

The prospects for longer-term bonds are considerably less favorable. One popular sector that could be especially vulnerable is high-yield, or junk, bonds. Another is emerging-market debt, says Gareth Lyons, fund analyst at Morningstar, an investment-research firm in Chicago. Beyond the risk of political upheaval, bond markets in developing countries could also be roiled by rising U.S. interest rates, Lyons says.

Junk and emerging market bonds, along with small-cap stocks, could also suffer if investors begin to shy away from riskier assets in favor of higher-quality investments. Such a shift in market sentiment often occurs during periods of actual or anticipated economic

sluggishness.

What benefits from slower growth and an investor flight to quality? Large-cap growth stocks. As economic activity moderates, it's tougher for businesses to boost earnings. That tends to increase investor interest in companies with track records of predictable growth, and those are usually large corporations.

For many professional investors, their take on consumer spending dictates the large-cap bets they're placing. Some who foresee less ch-ching at cash registers are investing in General Electric, because its industrial and commercial products provide diversification from the consumer economy. These money managers tout Johnson & Johnson for much the same reason. The health-care giant has a revenue base that's diversified and independent of general economic conditions. In contrast, investors expecting consumer spending to remain robust are buying the retail and consumer discretionary stocks that the bears are dumping.

The brightest prospects for 2006 may lie overseas. According to Morningstar's Lyons, "The vast majority of global stock managers we speak with say foreign stocks continue to trade at a steep discount to their counterparts in the U.S. and represent better value overall." That's particularly true in Europe, Lyons adds, where many companies are cutting costs and divesting non-core subsidiaries in an effort to restructure and improve results.

One way to profit from the growth of developing economies is to stake claims in financial concerns, because those companies typically prosper as an economy mushrooms. According to Lyons, Kookmin Bank in South Korea and OTP Bank in Hungary, a play on Eastern Europe, are among fund managers' favorites.

However 2006 unfolds, opportunities abound. But it's important to select investments that complement existing holdings, rather than duplicate your current risk exposure, cautions Russell's Wood. "Before you make moves for 2006," he says, "be sure you know what you already own."